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NZ Dairy Situation Fonterra 'Trading Among Farmers'

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Report Highlights:

NZ Dairy Situation – Fonterra, "Trading Among Farmers", and the Dairy Industry Restructuring Act, July

2012

General Information:

Executive Summary:

On the June 25th, 2012, New Zealand dairy farmers who are shareholders of Fonterra (the country's leading cooperative milk processor/dairy products marketer, collecting about 89% of all milk produced in New Zealand) re-affirmed their support for changes to the cooperative's constitution, entitled "Trading Among Farmers" (TAF). Under TAF, Fonterra would no longer be required to issue and redeem farmer shares on demand, instead an exchange would be created that would allow farmers to trade shares among themselves. In addition, a separate fund would be established that allows for the first time, public investment in the performance of Fonterra shares. The public fund is to be established to ensure that adequate liquidity exists in the Fonterra share exchange. However, the public fund would not have voting rights in the Fonterra Cooperative. Under the new arrangement, Fonterra would no longer be required to retain liquidity (up to $600 million) to cover redemption risk.

Implementation of TAF necessitated changes to the Dairy Industry Restructuring Act (DIRA), the federal legislation which governed the Coops formation and operations. Importantly the freedom of entry/exit to the Coop by farmers was preserved in DIRA. DIRA regulates that the minimum size for the public fund is to be NZ$500 million. The methodology Fonterra uses to calculate the raw milk price paid to farmers was also encapsulated in DIRA, along with an audit function provided by the Commerce Commission. The amended DIRA was passed in to law on July 23rd, 2012.
These changes have not been without controversy. In the two years it has taken Fonterra to move TAF from an advanced concept to a working system, there has arisen a growing sense of disquiet and unease among Fonterra shareholders as to whether they were going down the right path and concerns were raised that perhaps the changes could lead to the eventual loss of control by farmers of their own company. At the same time, other players in the dairy sector complained that the amended DIRA doesn't go far enough in curbing what in their view were monopolistic tendencies of the biggest player.

Fonterra's "Strategy Refresh" also calls for a stronger focus on serving and developing markets in China, ASEAN, Latin America, and the Middle East/North Africa. At the same time Fonterra is looking to downsize its marketing force in the U.S. and is quoted as saying it is "rightsizing" its operations in the United States.

It is probably reasonable to comment that under TAF a larger permanent capital base will be made available to Fonterra so it can work its balance sheet harder and effect its global strategy more effectively. However, managing TAF and its ancillary entities will also involve a greater time input and there is a risk that the management of TAF could divert the Board's attention away from the core focus of governing the business.

History:

Founded in July 2001, Fonterra is a cooperatively owned (by approximately 96% of New Zealand's dairy farmers) company established as a result of the merger of the country's two largest dairy processing cooperatives (Kiwi Cooperative Dairies and New Zealand Dairy Group) and what was the statutory single-desk marketer, the New Zealand Dairy Board. The Dairy Board had been owned by all the processing cooperatives since 1996. The two dairy cooperatives that stayed outside the merger (Tatua and Westland) received cash compensation for their shares of the Dairy Board. This completed the de-regulation of the sector and meant that anyone was to free to export or import dairy products to/from New Zealand.

In the 11 years since its inception, Fonterra has gone from processing 1,111 million kg of milk solids (MS) in 2001/02, to 1,481 million kg MS in 2011/12. And whereas it once collected 95% of all milk produced in NZ it now collects approximately 89% of all milk. Fonterra has been a successful enterprise for its shareholders, making them some of the most profitable dairy farmers in the world. All of this accomplished with no government subsidies.

However over the years, some have opined that Fonterra hasn't lived up to its initial expectations. Early on there was conjecture that Fonterra could become New Zealand's version of Nestle, however, critics note that Fonterra has not grown in global reach or into the consumer brands to anywhere near the level that Nestle has achieved. It should be remembered however, that the first priority for the directors of Fonterra is the interest of its shareholders, the dairy farmers who supply the milk. In the first six years of its existence, the Coop paid out to its suppliers virtually all its profit, leaving very little for reinvestment. This contrasts with a company like Nestle which seeks to minimize input costs in order to maximize profits; its main suppliers are not its shareholders.

Fonterra is New Zealand's largest company, and sells 2.5 million metric tons (MMT) of dairy products, of which 2.1 MMT is sourced from New Zealand milk. Its turnover for the 2011 financial year was NZD $19.9 billion (US$16 billion). Dairy exports and exports of dairy related products account for 27% of NZ's total merchandisable exports.
The Commerce Commission (a competition/anti-trust watchdog group) opposed establishment of Fonterra in 2001. In order to circumvent the Commerce Act and the Commerce Commission's approval process the Government of the day passed the Dairy Industry Restructuring Act 2001 (DIRA) which allowed the merger to go ahead and regulated the giant Coop to behave like a good corporate

citizen.

Essentially DIRA established that farmers should have the freedom of entry and exit to the Coop and that the Coop share price would be published. From the outset, the Fonterra board decided to value the share price at a fair/quasi market price. This is quite a different structure to traditional coops, which typically have nominal share values and may be closed to new suppliers.
DIRA also regulated that Fonterra had to supply raw milk at a prescribed price to any new startup or other existing processor (up to 50 million liters per customer) in order to foster a competitive and efficient industry. This was mandated in an attempt to provide “contestability” at the farmgate for milk (in reality only a proportion of farmers can actually make a choice of processor in the short to medium term). The regulations allow for up to 5% of Fonterra’s total NZ collections to be diverted to alternative processors. Currently approximately 3% is being diverted. Sunset clauses to this provision would be triggered when 20% of total milk collected in either the North or South Islands is sourced directly from farmers by processors other than Fonterra.
DIRA regulated the administration of quota markets (primarily for cheese). Initially the rights to the quotas were held by Fonterra when it took over the Dairy Board. Each quota was regulated so that Fonterra had a limited time for exclusive use of the quota, after which any exporter could apply for quota volume.

Under DIRA Fonterra was also required to sell approximately half of its domestic milk and dairy products distribution and marketing businesses.

Background to TAF - Redemption Risk

The combination of Fonterra’s own constitution and the regulatory system under DIRA subject Fonterra to a regulatory environment not faced by most other conventional cooperatives. Specifically the provisions under DIRA which provides for free entry/exit of shareholders coupled with Fonterra’s constitutional requirement that shares reflect fair/full valuation means that the Coop faces an exposure to a potential run on its shares. To cover that exposure to redemption Fonterra is presently required to maintain liquidity on the order of $600m.
Under the current arrangements if the volume of milk is reduced significantly Fonterra is obliged to promptly redeem the unused “wet” shares at the published fair value (note: in order for a farmer to supply Fonterra he must purchase from the Coop one share at the published fair value for every kg of milksolids he supplies, this is the share standard) For example, in 2008 when Fonterra’s total supply of milk solids fell by 54 million kg due to drought conditions, it is estimated that the redemption of unused “wet” shares cost the Coop NZ$300 million (US$240 million) or close to 5% of the Coop’s total equity (NZ$6.5 billion (US$$5.2 billion)). If a similar situation arose today it is estimated that Fonterra’s exposure to redemption risk of unused shares could be as high as $600m.

Having to provision for this type of risk limits the Coops ability to use its balance sheet for more constructive uses such as market development/acquisitions or more capital intensive joint ventures.

This exposure to redemption risk was recognized by the Fonterra directors' from the outset but was deemed acceptable. However, as time went by the risk became less and less acceptable. In 2007 the directors put forward a proposal to restructure the Coop to mitigate redemption risk and make more capital available for growth. Inclusion of a partial float on the share market as part of the proposal was not palatable to shareholders and the proposal was rejected. The issue of redemption risk remained and in 2009 the Board chose to address it again, this time progressively by:

- changing the constitution to allow farmers to hold shares equivalent to 120 percent of their milk production (a 20 percent increase); and,
- altering the Boards policy on share valuation to fix the value at $4.52 until the restricted trade fair value methodology would recommend that the value is above $4.52.
- instituting a raw milk pricing methodology whereby there was a transparent separation of the price a farmer receives for his raw milk and the dividend/ profit distribution on a farmers shareholding, which went hand in hand with;
- formulating a planned dividend payment policy.

Trading Among Farmers (TAF) represents the 3rd and final stage for changes to Fonterra's constitution. Under TAF, it was proposed that farmer shareholders would be able to buy and sell co-operative shares between themselves through an exchange, rather than through the co-operative. This would still allow farmer shareholders to meet their obligations under the Share Standard, but also allow them to hold additional dry shares to provide for either future milk production growth, or for investment purposes. TAF would virtually remove Fonterra's exposure to redemption risk. In June 2010, TAF was presented to farmers. There was overwhelming support from the farmer-shareholders, with 78% of the total shareholder base voting, of which 89.95% voted in favor.

Fonterra states the key objectives of TAF are to:

- Ensure Fonterra remains a strong, sustainable co-operative with voting rights linked to milk production - including 100% farmer ownership and control.
- Remove redemption risk.
- Provide more flexibility for farmers with shareholdings.
- Provide permanent capital to drive the highest level of sustainable returns to farmer shareholders.
- Enable shares to be traded at well-discovered prices, replacing the current share valuation approach

In order to implement TAF, the Government stipulated that DIRA would need to be amended and that additional conditions would apply. These included:

For the Fonterra Farm gate milk price:

- embedding Fonterra's current milk price governance arrangements into the legislation;
- requiring Fonterra to publicly disclose information in relation to its milk price setting scheme; and;

- introducing a milk price monitoring/oversight regime using the Commerce Commission.

And for the Fonterra share price and TAF formation:

- a publically subscribed unit trust fund was to be created with a minimum fund size of $500 million as a pre-condition to launch of TAF,. The fund can invest in securities that will be a derivative of a Fonterra share receiving the same financial returns but having no voting rights within the Coop;
- a further pre-condition that Fonterra shares and fund securities be listed on a registered exchange at all times;
- locking-in key structural features of TAF in legislation to ensure that they are maintained post launch, such as the presence of Registered Volume Providers;
- prohibiting Fonterra from engaging in behavior with the purpose of hindering liquidity and fungibility (i.e. exchangeability of shares and units) of the TAF share and fund markets; and
- imposing obligations on Fonterra to ensure that fund investors have the ability to appoint/remove a fund manager, and the ability to Liquidate and terminate the fund.
- rules to govern the share valuation if TAF or the Fund is terminated for any reason.

These conditions have been set to meet the requirements under DIRA with respect to the free entry/exit and contestability for milk. Additionally they mandate that sufficient liquidity is maintained in the Fonterra Share Market to ensure fair and prompt price discovery.
However, in the time it has taken Fonterra to move from the concept stage to a working system, a significant minority of Fonterra shareholders has begun to raise doubts as to the overall benefits of the scheme and express concerns about the potential risks that could emerge. Essentially the concerns boil down to two major themes:

1. **The "Slippery Slope Argument"**: Farmers are concerned that letting outside investors near the levers of control could be a slippery slope, and eventually lead to farmers losing control of their company. Such concerns, however should be allayed by the conditions inherent in TAF e.g., 1) the securities invested in by the public are not actual Fonterra shares; 2) the Fund for public sector investment is currently limited to 25% of the total number of Fonterra shares issued; 3) and Fund unit holders do not have cooperative voting rights. Despite these conditions many farmers remained concerned that TAF would put them on a slippery slope to the eventual loss of control of the cooperative. Other council members acknowledge there are risks but maintain that these are no greater than many other threats to the Cooperative and can be successfully dealt with.

2. **The "Redemption Risk Mirage"**: Some farmers and commentators argue that TAF is not necessary because the redemption risk is not as great as the leaders of the company portray. They maintain that any potential risk could be handled through other mechanisms.

Where is TAF Now?

On June 25th, 2012 farmer shareholders had a second vote on whether to adopt TAF and the proposal was ratified for a second time. This time 85% of all shareholders participated in the vote, of which 66.45% supported adoption of TAF. This was a lower level of support than two years previously, a testament to the doubts creeping into the minds of some farmers as to the purported benefits of TAF. At the meeting the Board put forward a second resolution for a further six changes to the Constitution. This resolution failed narrowly with a 72.8% support level, whereas 75% was needed for approval. Key among the changes proposed in this resolution was a proposal to limit the potential size of the Fund for public investment to 20% of the total Fonterra shares issued, from the existing constitutional limit of 25%.

The Board is committed to launching TAF before the end 2012. However this is complicated by the failure of this resolution to pass. This in turn calls into question the Fonterra Shareholders Council's support which is needed for final implementation of TAF. The Fonterra Shareholders Council which is the official Coop watchdog over the Fonterra Board gave an indication of interim support, voting approximately 85% in favor prior to the Shareholders vote on June 25th, 2012. However there is the possibility they could withdraw their support if the upper limit for the Fund for public investment is not constitutionally limited to 20% of the total Fonterra Shares on issue.

TAF Management and Risk

The Board has set out a proposed Risk Management Policy in relation to the Fund for public investment and the number of Dry Shares in circulation. The Board has determined that for operational purposes the public Fund should be equivalent to 7-12% of total Fonterra shares issued. The actions the board has set out that it could take to mitigate risk and manage the flow of money to and from the Fund are:

a) Introducing or cancelling a Dividend Reinvestment Plan;
b) Operating a Unit and/or Share repurchase programme;
c) Increasing or reducing the Fonterra Shareholders Fund Transfer Limit; and
d) Issuing new Shares.
e) Buying back shares
f) Suspension of economic rights being sold to the Fund

Fonterra has estimated the cost of operating TAF at NZ$5-10 million per annum. In addition, management of the fund will create extra work for the Board's Audit, Finance and Risk Committee.

The New & Improved DIRA – Still a Tangled Web

The DIRA Mark III which became law on the July 23, 2012 contained all the provisions outlined in the section above "Background to TAF". Its passage cleared one of the Fonterra Boards' five pre-conditions for TAF to be launched. However it did not receive total parliamentary support with Labour, the Greens and NZ First voting against it. Primary among their concerns was the "Slippery Slope"

argument once TAF is implemented. DIRA has been highly significant and influential in the development of the dairy sector in New Zealand. The impact of the free entry and exit principal has meant Fonterra has evolved into quite a different entity to a conventional cooperative.
Fonterra has spent a lot of effort over the years litigating the Act and lobbying government for changes especially around the raw milk regulations. By the same token many other players in the dairy sector and consumer advocates have also worked to change DIRA both by direct government submission or lobbying.

In relation to raw milk pricing, the Commerce Commission is now required to undertake and publish the results of an annual qualitative assessment of Fonterra's milk price setting scheme. This assessment will focus on Fonterra's underlying assumptions, inputs and processes, rather than Fonterra's milk price itself. The assessment will then be measured against outcomes that would have arisen in a competitive market for farmers' milk. The Commerce Commission will not be required to reveal its calculations as to its estimate of raw milk price. The new Act is silent on what the Commerce Commission does with its findings apart from reporting to the Minister and making them public. The Act is also silent on what the Minister can do with the information.
In addition, DIRA has set out additional rules to become operational in the event of TAF failing or if it is terminated for any reason. The rules pertain mainly to how Fonterra will estimate its share price which is defined as having to be “fair”.

The Ministry for Primary Industries is still looking at the Raw Milk Regulations in DIRA in relation to the legislated supply of parcels of raw milk by Fonterra to its competitors. There may be further policy changes and either amendments to the Act or changes to the regulations which result from the Act.